As Discounts Grow and Yields Rise, Closed-End Funds Look Good Amid Market Turmoil

Friday, March 13, 2020

Chuck Jaffe, in The NAVigator podcast, interviewed John Cole Scott, chief executive officer at Closed-End Fund Advisors and executive chairman of the Active Investment Company Alliance.

John Cole Scott

Read the Q & A below as Chuck and John discuss the state of closed-end funds in the middle of the stock market's current meltdown. John notes discounts have grown wider since the market stepped back from all-time highs in February, notes that yields have become even more attractive, urges caution in the use of leveraged funds, and more.

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: John Cole Scott, founder of the Active Investment Company Alliance is here, and we are talking about closed-end funds and how the discounts are changing in the wake of the market's decline today in The NAVigator. This is The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund business, from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right directions. Joining us again today, it's John Cole Scott, who is of course the founder of the AICA, but beyond that he is also chief investment officer at Closed-End Fund Advisors. Now if you want to learn about the AICA, it's AICAlliance.org. If you want to learn about John, he's on Twitter @JohnColeScott, and you

can go to CEFadvisors.com or CEFdata.com to learn more about his firm and all he does. John Cole Scott, great to chat with you again.

JOHN COLE SCOTT: Good to be here, Chuck.

CHUCK JAFFE: We have seen a market, that in the last week, had one of the worst weeks in history. Closed-end funds, they were trading at discounts before the market got into the troubles that were then exacerbated by last week. Tell us how early closed-end funds started to show signs of trouble? Because the market peaked on February the 12th, it had the fastest run to a twenty percent decline, a bear market condition, that had ever occurred. But closed-end funds already trading at a discount on average, things got wider. I want to know, did they show it and has the widening of that discount made things even hairier? Or are things better and more opportunistic now?

JOHN COLE SCOTT: On February 20th we had the relative peak of discounts even in an absolute basis for the last ten years basically. It went down and that first week we had about a six percent move for the average fund looking at our indices for that benchmarking purposes. Then we had a nice four and a half percent bounce into March 4th. I would say that was the initial concern, then the relief rally around the structure. Then we've had discount widening since the 4th that went from ten and a half plus in a handful of days. So as we think of the way discounts are widening dramatically and violently today, it does remind us of the financial crisis, and I can say that some of the absolute discounts aren't quite as wide as they were in November of '08, when people were just panicking aggressively. I do feel like the difference is we came to this so quickly and you have many investors, we understand, use margin with closed-end funds because they go, "Hey, more yield," and that forces margin calls. Then you have people that just saw prices move so far, so fast, worse than the fall of '18, and we thought that was aggressive and violent.

CHUCK JAFFE: You just made a comparison to 2008. We know that that proved to be one of the greatest buying opportunities of all time. In this case, the market is still frothy and we haven't put in a bottom, and not that anybody needs to have perfect timing, but do you believe that it is time to be adding more or would you be waiting to see this shake out?

JOHN COLE SCOTT: The way that we've always approached our investment management portfolios at Closed-End Fund Advisors is to think about risk, think about taxes, think about income needs to build a portfolio. Then change the portfolio as you have differences in

sectors, or asset allocation, or opportunistically trading discount, or stepping away from dividend risk. I've always felt if you need cash, you shouldn't be paying me more than you're earning on cash to hold cash. The cash piece is a separate part for investors. Some advisors do that for their clients, we just do closed-end fund portfolios. I would say staying invested through it. The hard but good conversations we've had this week with our clients has been, "Okay, we've built a portfolio to react. We've built it to look at logical things to pay you your monthly income that you are looking for and to make sure that you never are a forced seller." So I would say now when we step into it you think, "Okay, where has there been dramatic movements, ten percent plus?" and if things actually get worse, we still can clip a coupon and recover. The muni market is an area and the preferred equity market we went to in December '18, some very attractive names there. Large moves and you're back to getting yields and liquid muni funds like the large Nuveen Fund, NVG; currently yields five and a half. Which seems low in historical times, but that was at four and a half a week ago. Suddenly I think it's worth owning it, and at a twelve discount it's an interesting way to own income that can handle whatever could happen in my opinion.

CHUCK JAFFE: Obviously not all discounts are created the same, and in this market -- leverage -- you talked about margin accounts and margin calls, that can be dangerous. Leverage within closed-end funds is something we've talked about on The NAVigator many times. Do people need to be particularly careful right now if they're looking at funds that are using leverage?

JOHN COLE SCOTT: It's a really, really good point. If you go back to the major differences between an open-end fund, an ETF, which is basically an open-end fund, and the closed-endedness of the closed-end funds, is the fixed capital structure, you don't have to have forced buying and selling in euphoric periods or panic periods. The one asterisk that we've been talking about since '15-16, and even was a mild issue in '08-09, was if your leverage levels, the amount of dollars borrowed, generally for most funds goes above fifty percent of your asset valuation and you're not able to pay a dividend. As we talked about, closed-end funds aren't only for dividends, but they're often for dividends. So that happened for a couple of funds in '08-09, but nothing that couldn't be fixed quickly, '15-16 that hurt the energy sector significantly, and again in the last week, we saw a handful; many MLP closed-end funds forced to take their leverage off. That is, I don't want to say impossible, but it's

impressive to think of because the managers we talked to had already modeled in fifty percent asset declines when they're managing their leverage and they've diversified their leverage. That's an area where I think the moves have been violent, even more violent and more aggressive, and then challenging going forward. We modeled for the buckets of funds that we like. There is still underlying dividend coverage of the underlying MLPs that can buffer some of this, but when you take a portfolio that was $1.35 and it becomes a dollar, you do have less income coming in, so I would expect some dividend cuts to happen in that sector. Our hope is for the funds that already had reasonable policies, it's more like a ten to twelve percent cut in our models, versus thinking twenty, twenty-five, thirty, or even ridiculous numbers are possible if you were overpaying your dividend.

CHUCK JAFFE: So you put it all together and it sounds like selective buying, very careful on the opportunities, but under those circumstances you're going to be getting great yield and good assets at a significant discount. All that being the case, is there an a name or two that stands out to you as like, "Man, this is an interesting opportunity right now"?

JOHN COLE SCOTT: I'm going back to managers that know their craft well. Right now BGB, the Blackstone Credit Fund is at a twenty discount, it's currently yielding eleven. No one's perfect, but if you think of who knows how to handle credit markets you can think of a handful of names, and Blackstone is one of them. I like that the mandate is to go long and short. Another area that we think you can get some cover in, with a short duration global high-yield bond fund, sounds a little crazy, Prudential Short Duration High-Yield Bond Fund. It's a good manager in the sector. It's a short duration should you eventually actually have that worry. It's at an eighteen discount and it's usually at ten and a half. So I'd say we can find quality managers in sectors that have discounts wider than ten, yields nine, ten, eleven, twelve, I think you can be paid to wait here. The last sector I'd like to talk about would be in the preferred equity space, where Flaherty & Crumrine has a fund, DFP; it currently is trading at a twelve discount and yielding eight and a half. One thing I like about that, is last year the dividends were ninety-one percent qualified dividends, so for tax-driven investors it's a far more useful place. I think being selective, focusing on the cashflow, and be willing to screen the market, because you knew volatility is the good and bad of closed-end funds. They give you daily liquid access, but the discounts can divert. What we're in now is a dramatic and significant move. It could go wider, I don't know the future. I've never known the future, but

I'd really say that it's a great place to focus on sustainable dividends because people get drawn back to that and the elastic upside can be as dramatically positive for investors as the dramatic downside.

CHUCK JAFFE: Great stuff, John. Thanks so much for sharing with us, look forward to chatting with you again down the line.

JOHN COLE SCOTT: Always glad to be here, Chuck.

CHUCK JAFFE: John Cole Scott is chief investment officer at Closed-End Fund Advisors in Richmond, Virginia. Learn more at CEFadvisors.com and CEFdata.com, and follow him on Twitter @JohnColeScott. He's also founder and executive chairman of the Active Investment Company Alliance, which brings you The NAVigator in conjunction with Money Life with Chuck Jaffe. I am Chuck Jaffe and you can learn more about my show at MoneyLifeShow.com. To learn more about closed-end funds and business-development companies, go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. The NAVigator podcast is available every Friday. On behalf of AICA, thanks for joining us. We'll see you again next week.

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Click the link below to go to the home page of Active Investment Company Alliance to learn more:
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